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EDITED TRANSCRIPT

FAF.N - Q3 2022 First American Financial Corp Earnings Call

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OVERVIEW:

FAF reported 3Q22 revenue of $1.8b, diluted EPS of $0.02, and diluted EPS excluding net investment losses of $1.62.

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CORPORATE PARTICIPANTS

Craig Barberio *First American Financial Corporation - Director of IR*

Kenneth David DeGiorgio *First American Financial Corporation - CEO & Director*

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CONFERENCE CALL PARTICIPANTS

Bose Thomas George *Keefe, Bruyette, & Woods, Inc., Research Division - MD*

John Robert Campbell *Stephens Inc., Research Division - MD & Research Analyst*

Mark C. DeVries *Barclays Bank PLC, Research Division - Director & Senior Research Analyst*

Mark Douglas Hughes *Truist Securities, Inc., Research Division - MD*

PRESENTATION

Operator

Greetings, and welcome to the First American Financial Corporation Third Quarter Earnings Conference Call. (Operator Instructions) A copy of today's press release is available on the First American's website at www.firstam.com/investor. Please note that the call is being recorded and will be available for replay by entering the -- I'm sorry, from the company's investor website and for a short time by dialing (877) 660-6853 or (201) 612-7415 and entering the conference ID 13733443.

I'll now turn the conference over to Craig Barberio, Vice President, Investor Relations, to make an introductory statement.

Craig Barberio - *First American Financial Corporation - Director of IR*

Good morning, everyone, and welcome to First American's earnings conference call for the third quarter of 2022. Joining us today on the call will be our Chief Executive Officer, Ken DeGiorgio; and Mark Seaton, Executive Vice President and Chief Financial Officer.

Some of the statements made today may contain forward-looking statements that do not speak strictly to historical or current facts. These forward-looking statements speak only as of the date they are made, and the company does not undertake to update forward-looking statements to reflect circumstances or events that occur after the date the forward-looking statements are made. Risks and uncertainties exist that may cause results to differ materially from those set forth in these forward-looking statements.

For more information on these risks and uncertainties, please refer to this morning's earnings release and the risk factors discussed in our Form 10-K and subsequent SEC filings. Our presentation today contains certain non-GAAP financial measures that we believe provide additional insight into the operational efficiency and performance of the company relative to earlier periods and relative to the company's competitors.

For more details on these non-GAAP financial measures, including presentation with and reconciliation to the most directly comparable GAAP financials, please refer to morning's earnings release, which is available on our website at www.firstam.com.

I would now like to turn the call over to Ken DeGiorgio.

Kenneth David DeGiorgio - *First American Financial Corporation - CEO & Director*

Thank you, Craig. The slowing economy and rapid increase in mortgage rates continued to pressure our residential title business. Despite the challenging market conditions, we achieved revenue of $1.8 billion and earnings per diluted share of $0.02 or $1.62 per share excluding net investment losses. In our title segment, we delivered a pretax margin of 9.9% or 13% excluding net investment losses.

Two key factors along with our continued focus on expense management, favorably impacted our third quarter financial results. First, our commercial business continued its strong performance, and we remain on track to deliver another record year; second, we continue to capture the benefit of higher interest rates at our bank, on other escrow and tax deferred exchange balances and in our investment portfolio.

This quarter, investment income in our title segment increased to $105 million, up 114% compared to last year. Based on the current forward curve for Fed funds and assuming escrow balances remain at current levels, we believe investment income in our title segment could be $600 million in 2023. Mark will go into greater detail concerning these assumptions.

Refinance has been declining since early last year, so it's now near trough levels and no longer a significant contributor to our financial results. Our open purchase orders were down 23% this quarter, with orders declining each month throughout the quarter. And so far in October, this trend has continued with purchase order -- open orders down approximately [35%] compared to last year.

As we discussed on our last call, we remain committed to investing in strategic initiatives that support our company's long-term growth and operational efficiency despite our near-term impact on profitability.

Our initiative to deliver instant title decisioning for purchase transactions, Endpoint, our digital title and settlement company continue to make progress. ServiceMac, our mortgage subservicing business is rapidly achieving scale, and we now expect ServiceMac will be profitable in the final quarter of the year, a significant improvement from the $11 million pretax losses booked in the second quarter.

Despite the challenging environment ahead of us, we believe the company is well positioned to emerge from this cycle even stronger. The market has shifted away from refinance towards purchase and commercial transactions which is where we are stronger. And consequently, we are growing our market share. We are also the only title company that has a bank, which enables us to better capitalize on higher interest rates.

Our strong balance sheet will allow us to continue to invest in key strategic initiatives, pursue acquisitions as well as return capital to shareholders. I note that since the beginning of this year, we have repurchased approximately 7% of our shares outstanding as of the end of last year.

In closing, I want to thank our employees for all their hard work and accomplishments as we navigate our way through a difficult market. Relationships are key to our business, and it's our talented and dedicated people who provide the connection to our customers that ultimately drives our company's success. Given the importance we place on our workplace culture, I'm proud that First American was recently named one of the best workplaces for women by Great Places to Work and Fortune Magazine for a seventh consecutive year.

Now I'd like to turn the call over to Mark for a more detailed discussion of our financial results.

Mark Edward Seaton - *First American Financial Corporation - Executive VP & CFO*

Thank you, Ken. I'll begin with commentary on this quarter's results, followed by a discussion of a few key topics, including our venture portfolio, our outlook for investment income and the financial impact of a few of our strategic initiatives.

This quarter, we earned $0.02 per diluted share. Included in this quarter's results were $1.60 of net investment losses. Excluding these losses, we earned $1.62 per diluted share. Three items contributed to our net investment losses this quarter: First, we incurred $126 million of unrealized losses related to our venture portfolio; second, we recognized $50 million of losses related to mark-to-market adjustments in our public equity portfolio.

Finally, we realized $50 million of losses on our fixed income portfolio in connection with our tax planning strategies. In terms of our venture portfolio, we booked $126 million of net unrealized losses this quarter. This compares to $276 million of net unrealized gains in the third quarter of last year. As of September 30, including our investment in OfferPad, which is now publicly traded, we have invested $398 million in our venture strategy, which has a carrying value of $448 million.

Revenue in our title segment was $1.9 billion, down 12% compared with the same quarter of 2021. Commercial revenue was $260 million, a 1% decline over last year. Our escrow balances totaled $12 billion at the end of the quarter, up from $11 billion at year-end, which indicates a healthy pipeline for commercial activity as we approach the seasonally strong fourth quarter.

Purchase revenue was down 15% during the quarter, driven by a 23% decrease in the number of orders closed, partially offset by an 11% increase in the average revenue per order. Our average revenue per order for purchase transactions continued to benefit from recent acquisitions of escrow companies in Southern California. We include escrow revenue from these transactions in the numerator without a corresponding title order in the denominator.

Excluding acquisitions, average revenue per order would have up 1%. Refinance revenue declined 68% relative to last year due to the increase in mortgage rates. In the agency business, revenue was $910 million, down 9% from last year. Given the reporting lag in agent revenues of approximately 1 quarter, these results reflect remittances related to Q2 economic activity.

Our information and other revenues were $279 million, down 9% relative to last year. The decline was a result of lower transaction levels across several business units, driven by the decline in residential mortgage originations, including the company's data, property information and post-close services.

Investment income within the Title Insurance and Services segment was $105 million, a 114% increase relative to the prior year.

I want to take a minute to discuss how to think about our investment income for 2023. As we've stated previously, we expect to generate $15 million to $20 million of annualized investment income in the title segment for each 25 basis point increase in the federal funds rate.

In the third quarter, we generated $105 million of investment income. That result didn't reflect the full quarter of the Fed's 75 basis point increase in July or the 75 basis point increase in September. In addition, according to the forward curve, the market is projecting another 7 rate hikes in the middle of next year. We believe our investment income in the title segment could be $600 million in 2023, assuming our escrow deposits remain at current levels.

This excludes any growth in third-party banking deposits as well as the benefit from reinvesting paydowns and principal maturities into higher-yielding securities. If our book yield on our investment portfolio was reset to the market yield, it would increase our investment income by an additional $185 million annually.

Investors often ask what the Street is missing about our company, and our answer is that the market doesn't appreciate the benefit we receive from investment income as a result of higher interest rates. And because we own a bank, we are better positioned to capitalize on a higher rate environment.

On the expense side, we are reducing expenses in areas of the company that are being impacted by the slowdown in residential activity. Excluding acquisitions, our success ratio was 39%, meaning that our net operating revenue declined 22% relative to last year, and our personnel and other operating expenses declined 13%. Pretax margin in the title segment was 9.9% or 13.0%, excluding net investment losses.

As Ken highlighted, we continue to invest in businesses and innovation initiatives that we believe will positively contribute to our profitability in the long term. But at this point in our life cycle, adversely impact our financial results. Last quarter, we discussed 3 initiatives: ServiceMac, Endpoint and instant decisioning for purchase transactions, which together generated a pretax loss of $16 million this quarter, impacting our pretax title margin by 100 basis points. However, the drag on margin improved by 50 basis points since the second quarter, primarily related to improvements at ServiceMac.

Turning to the Specialty Insurance segment. Total revenue in our home warranty business totaled $105 million, down 3% compared with last year. Pretax income in home warranty was $4 million, down from $9 million in the prior year. Excluding net investment gains and losses, pretax income was $6 million, down from $9 million last year. The loss ratio in home warranty was 59%, up from 57% in 2021, driven by a higher severity of claims.

In our property and casualty business, we had no revenue in the third quarter and only 6 policies remain. We incurred $10 million of losses mostly related to adverse claims development. The effective tax rate for the quarter was 174%. Excluding the impact of our net investment losses, our tax rate would have been 23.1%, slightly less than our normalized tax rate of 24%.

In the third quarter, we repurchased 1.3 million shares for a total of $72 million at an average price of $53.31. So far in Q4, we repurchased an additional 339,000 shares for a total of $16 million at an average price of $46.46.

Our debt-to-capital ratio as of September 30 was 30.5%. This ratio is impacted by both our accumulated other comprehensive loss and our secured financings payable. Excluding these 2 items, which is more in line with how our banks view the ratio, our debt-to-capital ratio was 22.8%.

As of September 30, we recorded an accumulated other comprehensive loss of $1 billion. This quarter, we elected to sell fixed income securities, which produced a $50 million capital loss in connection with our tax planning strategy, which will offset capital gains we recognized in 2019, 2020 and 2021. When combined with further actions we will take in the fourth quarter, we expect to generate $24 million of cash to the holding company as a result of the strategy.

Our remaining unrealized losses in our investment portfolio are split between our bank and our insurance companies. We don't need to liquidate the portfolio for liquidity purposes and the average credit rating of the portfolio is AA-. So we expect to recapture the amount of accumulated other comprehensive loss into equity borrowing any additional tax planning strategy strategies we may exercise.

Now I would like to turn the call back over to the operator to take your questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions)

Our first question comes from the line of John Campbell with Stephens Inc.

John Robert Campbell - *Stephens Inc., Research Division - MD & Research Analyst*

Mark, I think you said it twice, I want to make sure, you said $600 million in title investment income for next year?

Mark Edward Seaton - *First American Financial Corporation - Executive VP & CFO*

That's right. That's assuming that the forward curve plays out like it's expected to and our escrow balances remain at current levels. As that happens, we should be around $600 million. That's right.

John Robert Campbell - *Stephens Inc., Research Division - MD & Research Analyst*

Yes. I mean I think even where consensus sits right now, I don't -- you could probably see much less of those hikes and probably lower deposit level and you're still going to be way above that. So nice work there. On the severance expense, could you talk today to the annualized kind of run rate

savings from that? And then just as we think about the market, if it sours a little bit from here, maybe the actions you guys would be looking to take?

Mark Edward Seaton - *First American Financial Corporation - Executive VP & CFO*

I would just say we've reduced our headcount in places that are being affected by the residential markets. We had $6 million of severance this quarter. I think we had $5 million last quarter. So that's just stuff that we continue to have our eyes on.

Kenneth David DeGiorgio - *First American Financial Corporation - CEO & Director*

Yes. John, I'll add. I mean, this obviously isn't the first downturn we've seen in 130-plus years, and we're highly focused on expense management, that we started on expense management when we saw the downturn coming very early this year. And we will continue to calibrate our expenses to the market.

John Robert Campbell - *Stephens Inc., Research Division - MD & Research Analyst*

Okay. Makes sense. And then just kind of thinking about the industry here. I mean, I saw the rule changes from Fannie and Freddie around the acceptance of the attorneys, I think in letter -- you guys have seen some -- I guess we've seen some smaller proptech players kind of launching new offerings.

And then a couple of weeks ago, I think it was United Wholesale talked about ramping up its own offering and then also originate mortgages without the lenders title insurance. I'm just curious about how you guys are viewing that? Is that more noise? Or is it something that you're going to look to address?

Kenneth David DeGiorgio - *First American Financial Corporation - CEO & Director*

Yes, yes. I mean it's a good question. I mean I think, obviously, they've -- these attorney opinion letters generated a lot of press. But I don't think -- so far, we haven't really seen much of an impact. But obviously, we're monitoring it closely. I think that once lenders and the GSEs appreciate the limitations of AOLs, I mean some of the things we've seen, for example, that have to prove negligence against lawyers, which is hard to do. There might be a statute of limitations. It's not clear if the coverage is for the life of a loan.

And I think the biggest thing is there's no cost of defense in some of these -- in most of these policies, all these policies we've seen, which is interesting because I think they were originally built to help low and moderate income borrowers who actually are probably the least able to bear the costs associated with defending title. So we're watching it, but so far, it hasn't been really impactful.

Operator

Our next question comes from the line of Mark DeVries with Barclays.

Mark C. DeVries - *Barclays Bank PLC, Research Division - Director & Senior Research Analyst*

I was hoping you could discuss what you're seeing in the commercial pipeline here, kind of relative areas of strength and weakness, how that's kind of been evolving in recent months? And also how that may differ from what we can see looking at the more visible kind of institutional larger side of the commercial real estate market.

Kenneth David DeGiorgio - *First American Financial Corporation - CEO & Director*

I'll start, Mark, and then Mark can chime in if necessary. But I think as we had indicated, we had a very strong Q3. Our revenue was only down 1% compared to a very strong Q3 of 2021. So I think that sort of bodes well for how we're going to go into the fourth quarter. And I think as Mark mentioned in his remarks, our escrow balances are up, which indicates a real -- a pretty strong pipeline.

And we've seen strength in the third quarter across geographies and asset classes, and it's probably all the things you'd expect. Multifamily was doing very well, industrial and development site. Looking at into 2023, I think we probably see commercial coming off a bit, probably more towards what we would say our normalized levels.

There's still some capital chasing deals but it is softening a bit. But again, keep in mind, when I say going towards more normal levels. We're coming off of a record-setting 2021, what we expect to be a record-setting 2022, 2022 will beat 2021. So we think commercial will still be pretty strong next year.

Mark C. DeVries - *Barclays Bank PLC, Research Division - Director & Senior Research Analyst*

Okay. Got it. And then just turning back to the investment portfolio. Mark, are you looking to extend duration at all where you can -- to try and take advantage of the higher rates there?

Mark Edward Seaton - *First American Financial Corporation - Executive VP & CFO*

It's not part of our strategy. Our duration has extended. I mean, typically, when you look at it on a consolidated basis, our duration has been the low 4s. And today, it's in the high 4s just because mortgages have extended. But I wouldn't say that's part of our strategy to go longer. The average duration of our liabilities is around 5 years, and so we feel pretty comfortable with where we are right now.

Mark C. DeVries - *Barclays Bank PLC, Research Division - Director & Senior Research Analyst*

Okay. Got it. And I think you qualified the investment income guidance around escrow deposits staying where they are. What do you think directionally? Are they -- just given all the different market dynamics, you see them more likely to held higher or lower kind of hold this level here?

Mark Edward Seaton - *First American Financial Corporation - Executive VP & CFO*

Well, there's a few different things at play, Mark. A roughly -- a rough number is about 70% of our escrow deposits are commercial related. So if commercial is down next year, everything else being equal, our escrow deposits be down. But the one thing that we have that offsets that is that we're growing our deposits from third-party banks. We talked about ServiceMac. We've got $1 billion of subservicing deposits at our bank today and a year ago, it was zero.

And we think that number will continue to grow, and that's going to help offset some of the potential softness that we might see. So those are 2 kind of competing things we'll have to kind of see how that plays out over the next couple of years.

Operator

(Operator Instructions)

Our next question comes from the line of Mark Hughes with Truist Securities.

Mark Douglas Hughes - *Truist Securities, Inc., Research Division - MD*

Yes. Thank you. Appreciate it. Mark, you mentioned that the -- you have the potential to possibly capture another $185 million in investment income, if you got the full benefit of the higher rates. Is that -- if we assume your duration is in the high 4s and the portfolio is turning over, normally, you capture 20%, 25% of that maybe over the coming 12 months. Am I thinking about that properly?

Mark Edward Seaton - *First American Financial Corporation - Executive VP & CFO*

I think that's the right way to think about it, yes. So the $600 million that we talked about, that's just variable. I mean that's just assuming that Fed raise isn't all like our cash balances and our variable rate securities will reset pretty immediately. But we also have this fixed income portfolio, it just takes longer. And so that's what that $185 million is. And given the duration of high 4s, roughly 20% to 25% of that will turn over every year. And that is -- so that would be a benefit that's in addition to the $600 million.

Mark Douglas Hughes - *Truist Securities, Inc., Research Division - MD*

And then did you give order trends so far for October? You've given some good general thoughts about the outlook, but did you give any specific numbers for October?

Mark Edward Seaton - *First American Financial Corporation - Executive VP & CFO*

In October, our purchase orders, our open purchase orders are down 38% -- sorry, 35%, 35% relative to last year. Our refinance orders are about $400 a day, and that's up down 73% from last year.

Mark Douglas Hughes - *Truist Securities, Inc., Research Division - MD*

And then anything on the commercial side?

Mark Edward Seaton - *First American Financial Corporation - Executive VP & CFO*

Commercial side, our open orders are down about 30% relative to last year.

Mark Douglas Hughes - *Truist Securities, Inc., Research Division - MD*

And then in the -- I think I thought you had still a $10 million loss from the reserve strengthening on the P&C business. What's the magnitude of the reserves that are still left over there? And you think this catches all that? Or is there still potential for more?

Mark Edward Seaton - *First American Financial Corporation - Executive VP & CFO*

Right now, we've got about $20 million in reserves for our P&C business. And it's at the final stages of winding down. So we're looking into next year, the losses will be negligible.

Operator

Our next question comes from the line of Bose George with KBW.

Bose Thomas George - *Keefe, Bruyette, & Woods, Inc., Research Division - MD*

From a share buyback perspective, does the increase in your leverage because of your negative AOCI marks create any constraints? Or do you look through those marks? And in your comments, you noted that the banks look through those as well.

Mark Edward Seaton - *First American Financial Corporation - Executive VP & CFO*

I wouldn't say it creates any constraints. I mean, obviously, every company has some constraints. But looking at our debt to cap at 22% now, that's a really comfortable place to be. It gives us a lot of flexibility to execute any buyback or any strategies we might have.

Bose Thomas George - *Keefe, Bruyette, & Woods, Inc., Research Division - MD*

Okay. So that makes sense. But basically, the question was will you focus more on the leverage AOCI marks when you're making those positions?

Mark Edward Seaton - *First American Financial Corporation - Executive VP & CFO*

That's right.

Bose Thomas George - *Keefe, Bruyette, & Woods, Inc., Research Division - MD*

Okay, great. And then actually switching over to the -- you noted that the Endpoint and ServiceMac drag on the margins was, I guess, its like a 100 basis points this quarter. How do you see that trending over the next few quarters?

Mark Edward Seaton - *First American Financial Corporation - Executive VP & CFO*

When you look at them all together, we think it's going to just keep getting better. I mean we're really pleased with how ServiceMac is progressing. They're going to breakeven here in the fourth quarter, and we feel like they're well on their way to profitability next year, and that doesn't include any benefit that we get at the bank for their deposits, too. So it's hard to say where that 100 basis points is going to go. But we feel pretty confident that the losses will narrow in the fourth quarter and continue to narrow into next year.

Operator

(Operator Instructions) Our next question is a follow-up from the line of John Campbell with Stephens Inc.

John Robert Campbell - *Stephens Inc., Research Division - MD & Research Analyst*

Just wanted to jump back to the Specialty Insurance segment, mainly on just home warranty. Two-part question though. First, I'm just curious about how to kind of think about the growth path from here. I know the real estate channel is a pretty important kind of driver of that growth. I wanted to check maybe on the health of the other channels and then also just kind of get an update on pricing. And then the second part of that, just curious about pretax margin just for home warranty. I think last year, it was around 13%. I think you've seen that a bit higher in past years. So just kind of what -- how to think about a kind of good margin target there?

Kenneth David DeGiorgio - *First American Financial Corporation - CEO & Director*

Yes. I'll start and then Mark can finish up on it. But we feel good about the home warranty company. I think as we noted, the revenue was down 3%, and that's largely driven by, as you indicated, that real estate channel. Anything that's tied to real estate transactions is going to suffer. But we

have had an offset to the decline in real estate channel from prices. So we have been raising price, and there's some additional -- there's going to be some additional opportunities to raise price, and we'll do that.

Also, we're getting a lot of traction in our direct-to-consumer channel. So that's performing well. And then we're also seeing renewal rates perform much better. So on the whole, we're pretty optimistic about where the home warranty company is going.

Mark Edward Seaton - *First American Financial Corporation - Executive VP & CFO*

Just in terms of the margins, John, this quarter, home warranty had a 6% margin, but it's typically -- it's a very seasonal business, and it's kind of seasonal to our title business. So typically, Q4 and Q1 are the most profitable quarter. So really, we think about it on an annualized basis, the home warranty business is 12% to 13-ish pretax margin.

Operator

Ladies and gentlemen, there are no additional questions at this time. That concludes this morning's call. We'd like to remind listeners that today's call will be available for replay on the company's website or by dialing (877) 660-6853 or (201) 612-7415 and entering the conference ID number 13733443. The company would like to thank you for your participation. This concludes today's conference call. You may now disconnect your lines.
